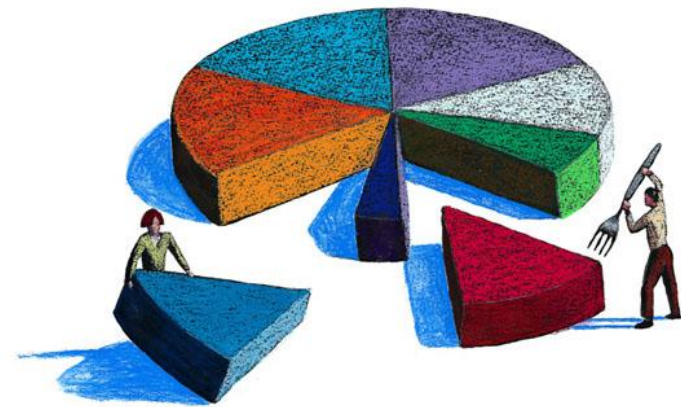


Presented by: Ms. Loretta Fong

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Fraud Close Encounter



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About the speaker

Ms. Loretta Fong, Partner, Assurance, PwC Hong Kong

Ms. Fong has extensive experience in providing accounting, audit, capital markets and consulting services to public and private companies. Leveraging the strong international background, Ms. Fong has led and advised on numerous substantial transactions including acquisitions, disposals and privatization of Hong Kong listed companies and registrants with the Securities & Exchange Commission (SEC) of the United States.

Ms. Fong currently has a number of external appointments including the board member of the Ocean Park and Vice-Chairman of Finance & Administration Committee of Hong Kong Young Women's Christian Association (YWCA). She is also a council member of the HKICPA and sits on a number of committees.



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What are auditor's responsibilities under HKSA?



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Auditor's Responsibilities with respect to Fraud

*“Obtaining **reasonable assurance** that the financial statements taken as a whole are free from material misstatement, whether caused by **fraud** or error” (HKSA 240, paragraph 5)*

Two types of intentional misstatements are relevant to the auditor, that is, misstatements resulting from **fraudulent financial reporting** and misstatements resulting from **misappropriation of assets**

HKSA, paragraph 10: *“The objectives of the auditor are:*

- a) To identify and assess the risks of material misstatement of the financial statements due to fraud;*
- b) To **obtain sufficient appropriate audit evidence** regarding the assessment risks of material misstatements due to fraud, through designing and implementing appropriate responses; and*
- c) To **respond appropriately to fraud or suspected fraud identified** during the audit.”*



Auditor's Responsibilities with respect to Fraud

Why this Session?

- ❑ Share experiences based on recent examples:
 - How frauds were perpetrated
 - how engagement teams dealt with these situations

- ❑ Summarize lessons learnt as key takeaways



Case 1



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Fraud Close Encounter – Case 1

Background

- X company is a listed group engaging in manufacturing of apparel products
- During the year, there was a change in controlling shareholder and the Company has undergone a general offer
- The general offer document disclosed that the new controlling shareholder is engaged in asset management business in the PRC
- Engagement team has placed background searches on the new controlling shareholder – no adverse or negative findings were revealed



Fraud Close Encounter – Case 1

Further background

- Towards the end of the financial year end, the Group obtained the relevant license and commenced money lending business in HK
- Significant amounts of loan receivables existed as at the year-end date
- The year-end loan receivables were made to three individuals. Additional loans were also made to three other individuals after year end
- Each of the individual loan amount was over HK\$10 million with lending rate of around 18% per annum
- All the loans were unsecured and the interests were only repayable on a quarterly basis
- Certain loans were of maturity period of over 12 months
- Certain of the loan amounts were released to certain payees instead of the borrowers under the instruction of the respective borrowers



Fraud Close Encounter – Case 1

Further background (Cont'd)

- Management was only able to provide the engagement team with the loan agreements in relation to loan receivables of the money lending business
- Other information such as borrower background and income proof, credit assessment details, loan granting and approval procedures ...etc. was not available
- In addition, the Group completed the acquisition of a Japanese juice producing company after year end – business also not related to the existing listed group's business



Fraud Close Encounter – Case 1

Further background (Cont'd)

- However, before the completion of the Japanese company acquisition and the related acquisition due diligence procedures, the Group granted two loans to the Japanese target before the year-end date with the purpose of providing working capital to the target



Do you see any red flags?



Fraud Close Encounter – Case 1

Engagement team's response

- Engagement team continued to push management to provide us with the details & background of the loan receivables as well as the procedures and controls in relation to the money lending business.
- Management was only able to provide us with the loan agreements and no other further detail information was available.
- Management were not able to provide us with the necessary audit evidence about these loan transactions, including:
 - *Information and documentation of the internal control procedures of granting the loans*
 - *AML and credit assessment procedures conducted on the borrowers together with the results thereon*



Fraud Close Encounter – Case 1

Engagement team's response

- *Management's evaluation of the background and financial ability of the borrowers*
- *Credit assessment details of the borrowers reviewed and assessed by the Group at the time of granting and approving the loans such as occupation and income proof, monthly salary details, ownership of properties ...etc.*
- *Underlying reasons for the said payment arrangements (to non-borrower payees) and the relationship of the borrowers and the counterparty recipients*
- *Detailed information supporting the Group's loan provision review assessment*

*If you were the engagement team,
what would you do?*



Fraud Close Encounter – Case 1

What had the engagement team uncovered?

- Engagement team reported the findings to the Audit Committee and the Board of Directors
- Apart from the loan agreements executed with the borrowers, management can only provide us the requested audit confirmations on the outstanding loan balances
- Engagement team has requested to interview with the borrowers and the recipients
- Management agreed to try to arrange the interviews but they indicated that it was out of their control as to whether the borrowers or the recipients would agree to attend the interviews
- No additional information or evidence was provided to the engagement team
- Audit Committee was on the side of the management



Fraud Close Encounter – Case 1



Key Takeaways

- Note for signs of unusualness – the facts speak for themselves
- Do the transactions make business sense? (e.g. in this case, unusual high amounts of unsecured loans to individuals without any detail information, relatively low lending rate, unusual payment arrangements, lack of credit assessment information and control policies)
- Be sceptical when there are new shareholders and new businesses injected
- Association risks

Case 2



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Fraud Close Encounter – Case 2

Background

- X Company is a privately owned enterprise listed in HK since 200x. Its major manufacturing plants are located in Xiamen.
- It is primarily engaged in manufacture and sales of consumable products.
- The core business of X Company had been shrinking in 2015 and 2016 with decrease of profit and revenue (excluding the new trading business described below).
- X Company was in a net current liability position at 2016 year-end and its cash balance significantly decreased comparing to 2015.
- Since 2016, X Company conducted a new trading business of another product (“P”) which does not related to its core business. P was sold to several overseas new customers (not end-users of P). Gross margin of trading was approximately 5%.
- X Company made significant amount of prepayments to a recurring raw material supplier (core business related) in 2016.



Fraud Close Encounter – Case 2

Further background

- There is no advance payment received from P customers' and X Company borrowed FX loan at 3% annual interest to finance the new trading business. X Company settled the payables with P's vendors upon delivery in 2016.
- The original credit term offered to trading business customers was 270 days after shipment date, and it was further revised to one year after customers' confirmations on receipt of goods. As a result, trading business related receivables were all unsettled at 2016.12.31, and they will not be due for settlement until May 2017 or later.



Fraud Close Encounter – Case 2

Further background

- The prepayments to the major raw materials supplier (not new supplier) in 2016 were made according to a Framework Purchase Agreement (“FPA”) signed in early 2016, and were significantly higher than actual purchase amount in 2016 (per purchase contracts signed during the year).



Do you see any red flags?



Fraud Close Encounter – Case 2

Engagement team's response

- As the overseas customers are new to X Company, engagement team requested for customer credit assessment documents and requested for interviews, and performed company search to understand if their operations and business size are reasonable (credit assessment document not available).
- ET arranged confirmation with customers to validate the transactions and balances.
- ET checked all the correspondence of contracts/agreements of purchases and sales, and validated shipping documents related to trading business.
- ET checked product P's market information in term of price, etc. and no negative information noted (but also not much market information available).



Fraud Close Encounter – Case 2

Engagement team's response

- ET checked payment details to FPA, sales/production budget, internal approval, and matched payment details to supplier bank account with no exceptions noted.
- ET searched background of the related suppliers of P but nothing indicating the suppliers are “related party”.

*All transaction related supporting obtained
except for customer credit assessment,
but is it enough?*



Fraud Close Encounter – Case 2

What are the management explanation?

- Management explained that they entered into new trading business because of successful experience of other Fujian entities in P's trading. Also because such new revenue source can help them reduce core business' revenue gap.
- Management explained that board meeting had approved extension of credit period in order to maintain good relationship with new customers.
- Management explained excessive prepayments was to secure a lower raw material price in response to possible price volatility.
- Management explained this supplier has long-term business relationship with X Company and has good reputation in the market.
- FPA signed in early 2016 and was in line with annual budget approved by management and BOD. Purchase contracts were entered during the year following production plan based on actual situation.



Fraud Close Encounter – Case 2

What final actions had the engagement team taken?

- Engagement team consulted risk management during the whole process.
- Engagement leader reported the findings and our concerns to the Audit Committee and the Board of Directors.
- The Audit Committee and Board of Directors decided to issue the annual report as scheduled and requested the auditor to issue audit opinion based on our work performed and evidence available to us.
- The auditor issued a qualified opinion as limitation of scope and clearly explained our concern especially on the commercial substance of the relevant transactions.
- HKSE issued enquiry letter to X within 3 working days (after annual report announcement) which listed numbers of questions on such transactions.



Fraud Close Encounter – Case 2



Key Takeaways

- Significant findings could be uncovered from healthy scepticism of unusualness noted.
- Note for signs of unusualness – do the transactions make business sense? (e.g. in this case, low profit but with significant exposure of AR credit risk, credit period is so long,)
- Carefully consider the explanation provided by management and always apply your own judgment from common business perspective.
- Sceptically assess the implications of the red flags and engage in early discussions with risk management.

Fraud Close Encounter – Case 2



Key Takeaways (Cont'd)

- Identify transactions with unusual business substance is NOT SO DIFFICULT!
- It may be difficult to obtain solid evidence to conclude certain transactions represented a fraudulent scheme, but we shall NEVER conclude our audit just based on signed contracts or confirmations when we identified significant red flags on the business rationale of certain transactions.
- Regulators have much more resources and means to seek for conclusive evidences. We need to demonstrate that as auditors we have exercised adequate professional scepticism – PREPARE FOR IT!

Case 3



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Fraud Close Encounter – Case 3

Background

- Z company is a listed group engaged in the provision of online services to small-to-medium sized companies (“SMEs”) in China. These SMEs pay subscription fees for promoting their products on Z company’s website.
- The company develops a proprietary software to be used on its website.
- The company uses a sales agent to help promote its business; more than 90% of the sales are sold through one single agent, A company
- The sales agents are provided with subsidies to perform marketing and promotion activities on behalf of Z company
- On the other hand, Z company employs more than 1,000 sales representatives promoting its business
- During the year under audit, certain copyrights were sold to third parties at a gain



Fraud Close Encounter – Case 3

Further background

- No invoices were issued to the end customers. From time to time there were cash/ cheques deposited with the company's bank account however there were no further details provided about the cheque deposits.
- No detailed bank statements were provided for the most active accounts of the company
- No information has been provided with respect to the types of the marketing promotional activities performed by the sales agent
- There is no evidence of any tax payments for services rendered in China



Do you see any red flags?



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Fraud Close Encounter – Case 3

Engagement team's response

- Engagement team obtained the end customer list from the company. A few of those end customers were selected to be placed calls with; either the phone number is invalid, or the end customer declared that they have not heard of Z company
- Engagement team tried to conduct a company search of the sales agent however this cannot be found its business registration. Management represented that it is an unincorporated entity
- The employees of the company are paid through a labour agent – Company L. Company L is owned by one of the employees of the company
- The buyer of the copyrights were having the same registration address as Company L

*If you were the engagement team,
what would you do?*



Fraud Close Encounter – Case 3

What had the engagement team uncovered?

- The website development was outsourced to a third party – whereby its shareholders are also the shareholders of the largest sales agent of the company
- This largest sales agent is in the same block as the company – just different floors (but that floor doesn't exist!)
- The engagement team reported the findings to management and the audit committee. Management represented that all these commonalities were all coincidental and are “common for business activities conducted in China”



Fraud Close Encounter – Case 3



Key Takeaways

- Is the business model making sense? Beware of service companies/ use of sales agents
- Checking supporting documents are important – not just tracing to bank deposits/ invoices
- Doing background search could be helpful – particularly for new customers/ suppliers
- Obtaining bank statements other than just the year-end one could be helpful to uncover anomalies

Case 4



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Fraud Close Encounter – Case 4

Background

- Y Company is a financial institution
- Its largest shareholder is a listed company in Hong Kong
- During 20x6, Y Company subscribed to a wealth management product (WMP) for a consideration of RMB 300 million.
- At the end of 20x6, Y Company received a cash distribution of RMB 40 million (a return of 13.3%) which was recorded as investment income
- The engagement team reviewed the subscription document and vouched the cash receipt. No exception was noted.

*Is this sufficient to conclude?
If not, what else may we consider to do?*



Fraud Close Encounter – Case 4

Further background

- Our team noted that Y Company effectively owned 40% of the WMP.
- However, the WMP statement showed that the distribution to Y Company represented 60% of the total distribution.
- We also asked for an analysis of the underlying investments. Y Company did not have such breakdown as the WMP never provided such details.



Do you see any red flags?



Fraud Close Encounter – Case 4

Engagement team's response

- The team asked the management why Y Company's share of distribution was disproportionate to its ownership. We were told that Y Company held special units in the WMP and was entitled to residual return (an additional return based on the total return over the whole period of the WMP).
- However, even if Y Company is entitled to residual return, it is normally distributed at the end when the WMP is wound down and not in the middle of the term of the WMP.
- Also, this explanation was not supported by the agreements received so far and the investment officer in charge of this investment has left.



Fraud Close Encounter – Case 4

Engagement team's response (Cont'd)

- The team contacted the WMP and was told other beneficiaries accepted a 6% return with any excess due to Y Company. The arrangement was oral. There was no written agreement.
- The team believed that the evidence obtained was not sufficient for us to agree to take all the distribution as income in 20X6.
- Y Company proposed to defer the distribution into 20x7 when the term of WMP would expire. When the WMP is terminated and final distribution is settled, Y Company can then recognise the distributions as income.



Fraud Close Encounter – Case 4



Questions

- If we contacted all the parties involved and got the information as described above, are we in the position to issue an unqualified opinion?
- Is deferring the investment income as at 31 December 20x6 a workable solution?
- What else can the team do?

Fraud Close Encounter – Case 4

What had the engagement team uncovered?

- The team believed that the evidence did not support deferring the income either. In fact, the evidence cannot support recognising 100%, or 0% or any % of the distribution as income in 20X6.
- After consulting with risk management, the team insisted that without further information, there will be limitation of scope qualification in respect of this investment income.
- As the regulatory reporting deadline was fast approaching, Y Company contacted its previous investment officer who joined Y Company's largest shareholder.



Fraud Close Encounter – Case 4

What had the engagement team uncovered? (Cont'd)

- Additional documents became available. The underlying assets of the WMP were actually bonds issued by the largest shareholder. There are agreements where the other beneficiaries accept a return of 6%.
- With the additional information, the team was satisfied with the accounting treatment. Additional related party disclosure was added to the financial statements.
- The initial lack of openness was because Y Company was worried about how the regulators would view Y Company's investment in its largest shareholder.



Fraud Close Encounter – Case 4



Key Takeaways

- Fraud findings could be uncovered from healthy scepticism of minor unusualness.
- Although side agreements not disclosed by management are hard to find, follow up on transactions that lack business substance is a good way to unearth other arrangements.
- Consult when there are suspicious findings.
- Consider the totality of facts before drawing a conclusion. Even though the investment income has been received in cash, the income being disproportionate to the ownership needs to be followed up.
- Get third parties evidence to corroborate management explanation. Although reaching out to the WMP did not yield any useful information, it is the right approach to take.
- Have the confidence to stand firm with our position. In this case, the team eventually obtained additional information to complete its audit.



Case 5



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Fraud Close Encounter – Case 5

Background

- X company is a listed group engaging in manufacturing of equipment for sale to industrial users
- During the year 20X5, the sales increased by more than twofold
- Most of the sales were concentrated on the last month and most of the shipments were made during the last few days of year end
- The engagement team has performed a review of the shipping documents and the related sales invoices, and performed site visits to selected customers and noted no particular issues



Fraud Close Encounter – Case 5

Further background

- During the audit of 20X6, the engagement team noted that the accounts receivable had deteriorated. Most of the sales made towards end of year 20X5 was not settled during the year 20X6 nor in 20X7 during the time of the 20X6 audit
- The credit period for these receivables were up to 180 days
- The engagement team sent accounts receivable confirmation requests directly to the customers and clean replies were obtained
- Management explained that the customers have not installed those equipment in their premises and they would only pay when they are satisfied with the installation. The delay in installation was due to the fact that the corresponding production lines were not yet ready



Do you see any red flags?



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Fraud Close Encounter – Case 5

Engagement team's response

- Engagement team checked the sales contracts with those customers and confirmed management's representation that the customers are not liable to pay until they formally accept the equipment's performance
- Engagement team conducted company searches of the customers and noted that most of the customers were newly incorporated entities towards end of 20X5
- Review of the shareholders and directors of these customers have identified no relationships of these individuals with the directors/ shareholders of the company

*If you were the engagement team,
what would you do?*



Fraud Close Encounter – Case 5

What had the engagement team uncovered?

- Engagement team reported the findings to the Audit Committee and the Board of Directors
- Major shareholders and directors sign confirmations declaring that they have no relationships with those customers
- The engagement team has eventually resigned from the audit
- The company was later on subject to investigation by the Stock Exchange and wound up



Fraud Close Encounter – Case 5



Key Takeaways

- Note for signs of unusualness – including unusual sales trends
- Are the transactions conducted in the normal course of operations?
- Are there market comparables?



Summary of Key Reminders



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Perspectives on fraud risk

Definition of fraud

- Fraud is a broad legal concept
- Our interest specifically relates to acts that can result in a material misstatement of the financial statements
- Fraud, unlike error, is intentional and usually involves deliberate concealment of the facts
- It may involve management, employees or third parties
- It may involve one individual or collusion

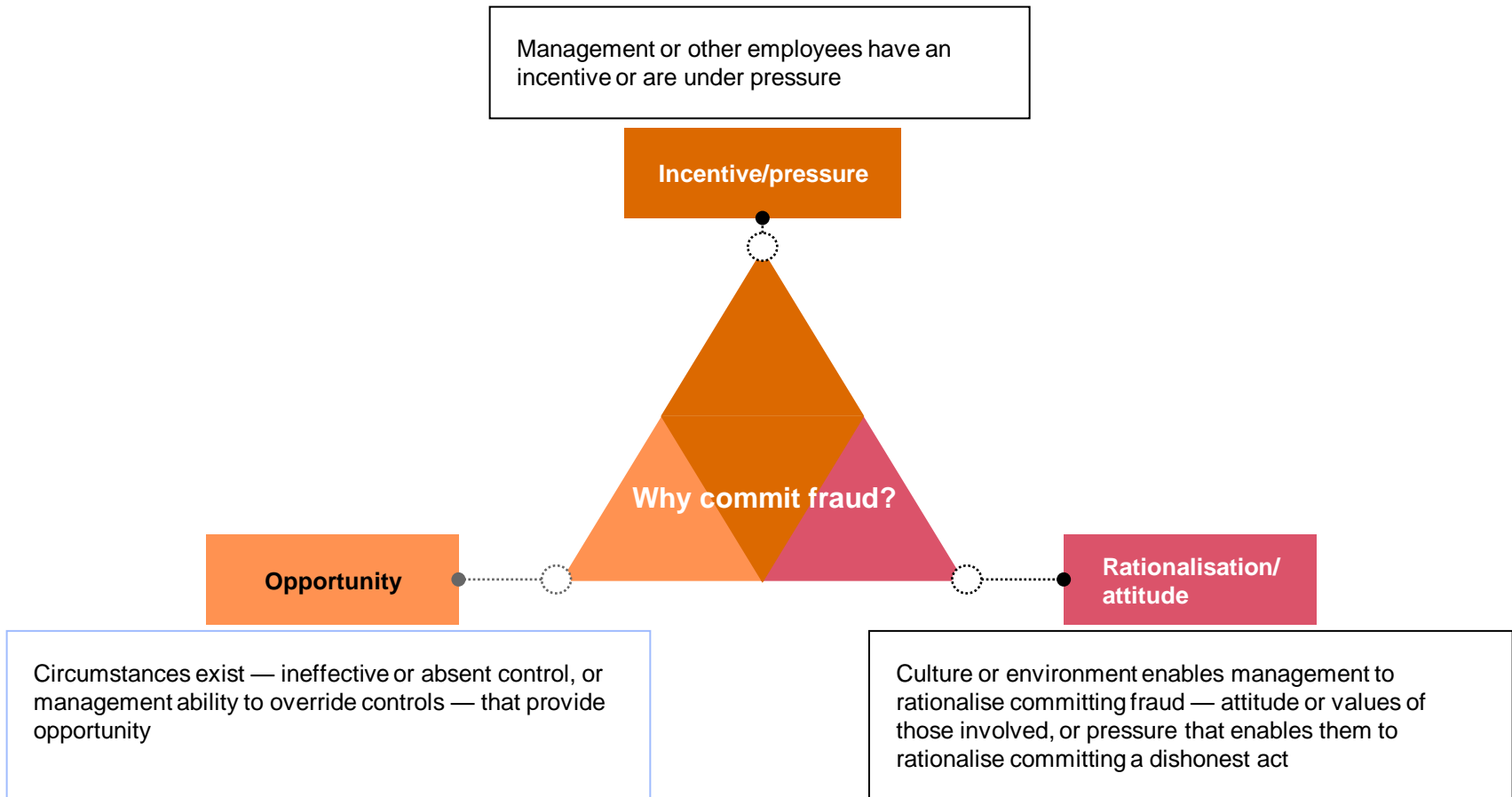
Misstatements related to fraud:

1. Misstatements arising from fraudulent financial reporting
 - Intentional misstatements or omissions of amounts or disclosures designed to deceive financial statement users
 - Usually involving the override of controls by management
2. Misstatements arising from misappropriation of assets
 - Involving theft and embezzlement of an entity's assets



Perspectives on fraud risk

Conditions under which fraud may occur



Fraud Close Encounter

Two common themes associated with the five fraud cases that we just shared:

Undisclosed agreements or transactions with counterparties

Transactions recorded with no business substance



What about misstatement arising from misappropriation of assets?

- non-segregation of duties in cash handling and financial reporting
- manufacturing of standard goods
- senior management expenditures
- inventory count at various locations
- channel stuffing



Fraud Close Encounter



Key Reminders

- Undisclosed agreement/transactions are difficult to identify. Yet with healthy scepticism it is still possible for engagement teams to uncover them.
- Do the transactions make commercial sense? Too good to be true?
- Do we have all the information to support the business rationale for the transactions? Are the terms comparable to market practices?
- What is the business substance of the transaction?
- Any indications that the new shareholders are misappropriating funds from the Company?
- Need to understand new shareholders background, possible connection with parties/or having background that we do not want to associate with?

Fraud Close Encounter



Key Reminders (Cont'd)

- Exercise healthy scepticism, identify red flags at early stage.
- Consult as appropriate.
- Increased risks for client engaging in a new business and at terms lack of supportable commercial sense.
- Consultation early to determine whether a request for investigation should be initiated with the Audit Committee.
- Options are available for auditors to modify our audit opinion (e.g. scope limitation) even if we do not have conclusive evidence to indicate actual fraud perpetuation.



What are the auditor's responsibilities under HKSA when a fraud/ suspected fraud is identified?



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Auditor's responsibilities when a fraud/ suspected fraud is identified

- If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters as soon as practicable to the **appropriate level of management**.
- If the auditor has identified fraud involving:
 - (a) Management;
 - (b) Employees who have significant roles in internal control; or
 - (c) Others where the fraud results in a material misstatement in the financial statementsthe auditor should communicate these matters to **those charged with governance** on a timely basis.



Auditor's responsibilities when a fraud/suspected fraud is identified (Cont'd)

- Where having discussed an identified suspected or actual instance of fraud which could have a material effect on the financial statements with those charged with governance and considered any views expressed on behalf of the entity and in the light of any legal advice obtained, the auditor concludes that the matter ought to be reported to a proper authority in the public interest, he would notify those charged with governance in writing of his view. If the entity does not voluntarily report the matter to a proper authority itself or is unable to provide evidence that the matter has been reported, the auditor would consider reporting it himself or the auditor may consider reporting directly to a proper authority in the public interest without delay. Legal advice may need to be sought before making the decision.



Auditor's responsibilities when a fraud/ suspected fraud is identified (Cont'd)

- Please also note that guidance on the auditor's responsibility to report direct to regulators in regulated industries is provided in Practice Note 820 "The audit of licensed corporations and associated entities of intermediaries", Practice Note 620.2 "Communications between auditors and the Insurance Authority", Practice Note 860.1 "The audit of retirement schemes" and Auditing Guideline 3.401 "Authorized institutions in Hong Kong" or Practice Note 830 "Reporting responsibilities of auditors under the Banking Ordinance".



Questions?



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